Testimony of

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On
The Extraterritorial Income Regime

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Chairman Baucus, Ranking Member Grassley, and members of the committee, thank you for the opportunity to appear before you today to present the views of Power Curbers, Inc., and the National Association of Manufacturers (NAM) on ways to promote the competitiveness of U.S. companies while respecting our international obligations under the World Trade Organization (WTO) agreement. I am Dyke Messinger, president and chief executive officer of Power Curbers.

The NAM, the nation's largest industrial trade association, represents 14,000 member companies (including 10,000 small - and mid-sized companies) and 350 member associations serving manufacturers and employees in every industrial sector and all 50 states. Headquartered in Washington, D.C., the NAM has 10 additional offices across the country.

Power Curbers manufactures and sells concrete paving equipment. Our machines are used in more than 80 countries to, among other things, build curbs, gutters and sidewalks — and even the railbeds for the Eurotunnel project. Founded in 1953, the company grossed $24 million in sales in 2001. Power Curbers, a family-owned company, employs 130 workers at its facilities in Salisbury, North Carolina, Cedar Falls, Iowa and White House, Tennessee.

The current extraterritorial income regime (ETI) — as well as its predecessors, the domestic international sales corporation (DISC) and the foreign sales corporation (FSC) — have been integral factors in increasing export activity by U.S. manufacturers. According to the IRS, of the roughly 4,300 FSCs in existence in 1996, 89 percent of them exported manufactured products. Congress first created the DISC in 1971 to level the playing field for U.S. companies — large and small — selling their products overseas. These three types of tax incentives created over the past three decades were designed to neutralize some of the tax advantages enjoyed by our foreign competitors located in countries with territorial tax systems, which generally exempt income earned outside the country from income tax and exports from value-added (VAT) and other consumption taxes.

Traditionally, much of the attention in this area has been focused on FSCs used by large companies. FSC benefits also are important to small - and mid-sized manufacturers that export. In fact, exporting goods overseas is more than a sideline for many of these smaller companies; it's a simple necessity of staying in business. Smaller companies often turn to export tax incentives to effectively compete in the global marketplace. According to an NAM survey in 2000, small - and mid-sized manufacturers saved, on average, about $124,000 annually by using a FSC.

It is critically important to continue to encourage export activity by these small companies. Of all the exporting manufacturers in America, 93 percent are small - and mid-sized manufacturers. These firms, which individually employ anywhere from 10 to 2,000 employees, together employ roughly 9.5 million people. Small - and mid-sized manufacturers that export add jobs 20 percent faster than firms that remain solely domestic, and are 9 percent less likely to go out of business.

For a company like Power Curbers, selling products in the international market means more than reaching a few additional customers. International sales contribute to the growth and health of Power Curbers, ensuring our survival. International sales account for 20 percent of Power Curbers' revenue, and these sales are responsible for 12 percent of profits.

In the past, Power Curbers used a foreign sales corporation (FSC) and we currently use the extraterritorial income regime. The benefits provided by FSC/ETI justify the additional risk and effort needed to go into overseas markets, price our products competitively from the outset, and compete. For example, the tax systems in some European countries heavily favor local suppliers; FSC/ETI helps level the playing field. You can't just pull away incentives that allow small and medium manufacturers to actively pursue overseas markets.

Moreover, the loss of tax incentives like those provided by FSC/ETI would have a tremendous impact on the company, affecting revenues and employment. There are many hidden costs in doing business internationally. In markets where margins are already thin, we would lose sales due to an uneven playing field. If these sales slumped, Power Curbers likely would have to lay off 5 to 10 percent of its workforce.

Given the imminent release of the WTO arbitration panel's sanctions report, we are pleased that the European Union recognizes the difficulty of the situation and has agreed to delay imposing any sanctions until at least 2003. However, five months is not enough time. It is clear that the international tax issues involved are complex and a considerable amount of time will be required to develop and implement an appropriate legislative response.

The simplest — and wrong — answer would be to eliminate the ETI and subsequently increase taxes on U.S. industry by almost $5 billion annually. This increase would largely affect manufacturers, who are the largest contributors to U.S. economic growth and the largest beneficiaries of the FSC/ETI rules. Small - and mid-sized manufacturers would acutely feel the burden, adding to the mounting problems of rising energy, insurance and health-care costs that limit the appeal of American exports. These adverse factors are compounded by the inability to pass increases on to consumers, due to the competitive nature of the global market. Thus, if ETI is repealed, it is critically important that any cost savings are used to benefit U.S. exporters.

Another inappropriate solution would be to ignore the ruling of the WTO. Refusal to comply with the WTO findings would subject U.S. industry to potentially $4 billion in annual retaliatory sanctions and have significant negative repercussions for U.S.-European trade relations.

Perhaps the most obvious way to comply with the WTO rulings and maintain international competitiveness would be to completely redesign the U.S. tax system, for example, by changing it to a territorial system. However, the sheer magnitude of rewriting the tax code and today's political climate limit the feasibility of this solution.

Ever since the ETI first came under attack, there has been an ongoing effort in the business community and on Capitol Hill to come up with a fair and equitable solution. As you well know, this is proving to be a difficult task.

No consensus has been found yet on an appropriate solution. Current proposals vary considerably, ranging from substituting other changes in the international tax area for FSC/ETI to a legislative framework and timeline to achieve compliance with the WTO rulings.

As a small, U.S.-based manufacturer, I am concerned that some of the proposed solutions are targeted to multinational corporations with subsidiaries, operations and employees outside of the United States. These changes will not benefit small exporters, like Power Curbers, with operations only in the United States and thus will not serve as an adequate substitute for FSC/ETI.

In crafting a proposal to address the FSC/ETI issue, it is imperative that the United States strive to maintain approximately the current level of benefits for all exporters and continue to work toward achieving a level playing field and a competitive environment for U.S. companies. At this point, it appears likely that the long-term solution will have to involve a combination of negotiations and legislation.

On the negotiations front, I support efforts to reopen this issue in the Doha trade round and negotiate to change the WTO rules so they provide similar treatment for indirect and direct taxes. On the more problematic issue of legislative action, the options to help small exporters are more difficult to identify in light of the WTO prohibition on tax benefits tied to exports.

From the legislative perspective, one approach would be to look at broad-based business tax relief and simplification of the tax code to ease our tax burden and make us more competitive overseas. Specific changes could include permanent income tax rate cuts, enhanced capital cost recovery, reduced capital gains tax rates, permanent repeal of the death tax and payroll tax relief. This type of approach, however, would significantly dilute the current benefits and fail to provide any type of export incentive.

I, along with other members of the National Association of Manufacturers, am grateful to Chairman Baucus and the Finance Committee for holding this hearing on ETI and international competitiveness. We look forward to working with you and other members of Congress and the Administration to resolve this issue in a fair and expeditious manner that satisfies the World Trade Organization, does not result in a significant tax increase on U.S. companies, avoids sanctions on U.S. products and encourages export activity by American manufacturers of all sizes.

Thank you for working to provide the tools for American manufacturers, large and small, to compete effectively with their foreign counterparts.